

## PROMOTING EQUITY FOR REIT INVESTORS

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### ***I. INTRODUCTION***

Real estate investment trusts ("REITs") are special entities created by Congress that enable small investors to obtain the investment benefits of real estate ownership. However, due to unfavorable tax characteristics compared to non-REIT ownership structures, taxable investors in REITs often cannot take full advantage of depreciation charges associated with the value of the real estate owned by the trust.<sup>1</sup> Such disparate tax treatment acutely offends the equitable principle that taxation among individuals engaging in the same activity should be consistently administered,<sup>2</sup> and it exists at a time in our nation's political

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<sup>1</sup> I.R.C. § 856(h)(3)(A)(i) (2006).

<sup>2</sup> See generally John A. Miller, *Equal Taxation: A Commentary*, 29 HOFSTRA L. REV. 529 (2000) (discussing equitable tax principles).

history when awareness of disparate tax treatment is at the forefront of tax policy debate.<sup>3</sup>

This Article proposes that Congress should amend subchapter M of Chapter 1 of the Internal Revenue Code (“IRC”) to make the basis limitations to REIT investors more similar to that of investors in limited liability partnerships or limited liability corporations (“LLCs”).<sup>4</sup> This would promote more fairness in the tax system, and encourage more individuals to invest in REITs, rather than more leveraged alternative real estate purchase structures.

Part II of this Article outlines the tax structure of a REIT and what is required of an entity in order to qualify as one for tax purposes. Part III discusses the legislative history of REITs and what purpose they were meant to serve. Part IV discusses why REITs do not fully accomplish their intended purpose. Part V details the disastrous consequences of over-investment in real estate, which occurred, at least in part, due to excessive debt-financing. Part VI offers proposed legislative changes that would further encourage individual investors of modest means to take greater advantage of the tax and diversification benefits of real estate through REITs.

## II. BACKGROUND OF THE REIT

A REIT is a tax and legal entity comprised of the contributed capital of shareholders<sup>5</sup> and is generally restricted to the acquisition of specific, real estate related assets.<sup>6</sup> Much like corporations, REITs are centrally managed<sup>7</sup> and have freely transferable shares.<sup>8</sup> Provided the REIT passes almost all of its net income to its shareholders as dividends, the REIT itself, as an entity separate from its shareholders, faces virtually no tax liability.<sup>9</sup> Thus, from a tax perspective, REITs function much like partnerships, in that income generally is generally taxed only once at the shareholder level.<sup>10</sup> The creation of the REIT in

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<sup>3</sup> See generally Warren Buffet, *Stop Coddling the Super-Rich*, N.Y. TIMES, August 15, 2011, at A21.

<sup>4</sup> 26 C.F.R. § 1.704-2 (2012).

<sup>5</sup> § 856(a)(2).

<sup>6</sup> § 856(c)(3).

<sup>7</sup> § 856(a)(1).

<sup>8</sup> § 856(a)(2).

<sup>9</sup> I.R.C. § 857(b)(2)(B) (2006).

<sup>10</sup> WILLIAM B. BRUEGGEMAN & JEFFREY D. FISHER, REAL ESTATE FINANCE AND INVESTMENTS 581 (Robin J. Zwettler ed., McGraw Hill Irwin 2005) (1954).

1960 opened up real estate investing to a new profile of investors, who now could have a freely transferable ownership interest<sup>11</sup> in a real estate derived asset<sup>12</sup> for the price of a REIT share.

In 1960, when Congress amended subchapter M of Chapter 1 of the IRC of 1954 and created the REIT,<sup>13</sup> legislators stated two motivations.<sup>14</sup> First, the real estate market at that time faced a drought of available financing. With REIT legislation, lawmakers sought to provide much-needed capital to the private development of real estate by lowering barriers to investment.<sup>15</sup> Second, champions of the legislation sought to give investors of modest financial means the benefits of real estate ownership. Prior to this legislation, real estate investment was mainly limited to those individuals with the financial resources to make a large-scale investment and with sufficient knowledge of the real estate business or access to a partner with such knowledge.<sup>16</sup> The advent of the REIT provided investors the inflation-hedge and diversification benefits of real estate investment, access to expert real estate managers and acquirers, and the opportunity to invest in high quality large-scale properties.<sup>17</sup> They also represented a highly liquid form of investing in real estate. Unlike a house or other rental property, a REIT share is an investment with no greater time-frame commitment or size than that of an ordinary share of stock in a publicly traded corporation.<sup>18</sup>

In the forty-nine years since its first formation, the REIT structure has achieved widespread popularity, both in the United States and abroad.<sup>19</sup> As demonstrated by the financial crisis of 2008, REITs have been both generally conservative borrowers and shrewd allocators of

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<sup>11</sup> § 856(a)(2).

<sup>12</sup> § 856(c)(3).

<sup>13</sup> BRUEGGEMAN & FISHER, *supra* note 10.

<sup>14</sup> H.R. REP. NO. 2020 (1960).

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> Theodore Lynn, et al., *Real Estate Investment Trusts Database*, §§ 5:1-5:8 (July 2011), <http://web2.westlaw.com/Welcom/Westlaw/default> (search database for “Real Estate Investment Trusts,” then click on database “SECREIT,” then click on “Table of Contents,” then click on “Chapter 5”).

<sup>18</sup> See Jack McCall, *A Primer on Real Estate Trusts: The Legal Basics of Reits*, TRANSACTIONS: THE TENNESSEE JOURNAL OF BUSINESS LAW 1, 3 (2001).

<sup>19</sup> See William Boston, *Many Made-in-Germany REITs Gear Up, Ahead of New Rules*, WALL ST. J., Oct. 14, 2009, at C10.

capital,<sup>20</sup> and have been resoundingly successful in providing a reliable source of capital for numerous large-scale real estate development projects and long-term investments across the nation.<sup>21</sup>

#### A. What is a REIT?

REITs are generally codified in Sections 856-860 of the IRC.<sup>22</sup> A REIT is similar to a regulated investment company ("RIC"), which owns several different assets and passes on the income received from those assets to its shareholders.<sup>23</sup> A REIT owns real estate assets and passes on the income from those assets to its own shareholders.<sup>24</sup> As its name suggests, a REIT's business is generally limited to real estate investment activities. To achieve the tax benefits allowed under these sections, a REIT must invest predominantly in real estate assets, including but not limited to properties held for rent<sup>25</sup> or mortgage-backed securities.<sup>26</sup>

Like shares in a corporation, each share of a REIT entitles an investor to a pro-rata share of the REIT's income. Unlike corporations, income distributed to shareholders is not subject to taxation at the REIT entity level because the REIT enjoys a deduction for dividends paid.<sup>27</sup> REITs allow shareholders the tax benefit of a single level of taxation, and in this respect REITs are similar to partnerships.<sup>28</sup>

<sup>20</sup> Stephanie Fitch, *REITs Could Thrive as Distressed Asset Buyers*, FORBES, Sept. 7, 2009, at 46.

<sup>21</sup> *Id.*

<sup>22</sup> I.R.C. §§ 856-860 (2006, Supp. 2007- 2008 & Supp. 2010).

<sup>23</sup> I.R.C. § 851 (2006 & Supp. 2010).

<sup>24</sup> I.R.C. § 857(a)(1) (2006).

<sup>25</sup> I.R.C. § 856(c)(5)(B) (2006).

<sup>26</sup> § 856(c)(3).

<sup>27</sup> I.R.C. § 857(b)(2)(B) (2006).

<sup>28</sup> I.R.C. §§ 701 (2006) & 857(a)(1)(A) (2006). To illustrate, assume that a corporation and a REIT each earn \$100, before taxes. Assume the corporation and the shareholder of either entity are both in the 35% tax bracket. The corporation pays \$35 of tax on their \$100 of income, whether they distribute the income or not. If the corporation then pays out its after-tax earnings of \$65, after the shareholder pays their taxes there is only \$42.25 in after-tax income left. (\$100 taxed at 35% at the corporate level, followed by \$65 dollars in after-tax earnings distributed to shareholders, then taxed at 35% to the shareholder). If a REIT earns \$100, before taxes, and provided they pay out all of that income to shareholders, the entity itself faces no tax liability. The \$100 in income is taxed solely at the shareholder level, who is in the 35% bracket in this example, leaving \$65 in after-tax income. This amount is almost 54% higher than the after tax return to the corporate shareholder. Note that this disparity decreases depending on whether the dividend qualifies for the special reduced 15% rate on certain qualified dividends of corporations, but a REIT shareholder

### *B. Qualifying as a REIT*

A REIT must be beneficially owned by 100 or more persons,<sup>29</sup> evidence such ownership by transferable shares or transferable certificates,<sup>30</sup> be taxable as a domestic corporation but for the provisions of the Code specifically applicable to REITs,<sup>31</sup> and be managed by one or more trustees or directors.<sup>32</sup> These requirements were enacted to ensure that a REIT has a central management team and multiple shareholders who can legally transfer their shares to another buyer. These structural requirements are in place to ensure that REITs fulfill their intended purpose as a vehicle for easily raising capital, as indicated by the “transferable shares” requirement,<sup>33</sup> and benefit a wide ownership base, as indicated by the “at least one hundred shareholders” requirement.<sup>34</sup>

Congress sought to limit the favorable tax treatment accorded to REITs to entities that invest in real estate related assets, not to businesses engaged in an active trade, like retailing or manufacturing. Therefore, in addition to the aforementioned organizational requirements, REITs must meet certain asset tests each year.<sup>35</sup> To ensure that the bulk of the trust’s investments are in real estate, Congress dictated that 75 percent of the assets of a REIT must be held in the form of real estate assets, cash and cash items, or government securities at the close of each quarter.<sup>36</sup> Real estate assets include real property, shares of other REITs, and stock or debt instruments<sup>37</sup> that are purchased with new capital, as long as they are not held for more than one year after the trust receives such capital.<sup>38</sup> Real property includes interests in real property and interests in mortgages on real property.<sup>39</sup>

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will always produce higher after-tax income in the shareholder’s hands.

<sup>29</sup> I.R.C. § 856(a)(5) (2006).

<sup>30</sup> § 856(a)(2).

<sup>31</sup> § 856(a)(3).

<sup>32</sup> § 856(a)(1).

<sup>33</sup> § 856(a)(2).

<sup>34</sup> § 856(a)(5).

<sup>35</sup> § 856(c)(4)(A).

<sup>36</sup> *Id.* In addition, a REIT must not have more than 25% of its assets in securities not described in subparagraph (A), including taxable-REIT subsidiaries, as well as other restrictions. § 856(c)(5)(B).

<sup>37</sup> “Stock or debt securities” refers to non-real estate related assets in this section. § 856(c)(5)(B).

<sup>38</sup> § 856(c)(5)(B).

<sup>39</sup> *Id.*

The Code is quite permissive in what types of real property interests it lets REITs own and manage,<sup>40</sup> but the term “interests in real property” does not include mineral, oil, or gas royalty interests.<sup>41</sup>

REITs must maintain a specific asset composition each year and must also meet two separate “income tests” on a yearly basis. Under the first income test, at least 95 percent of a REIT’s gross income for a taxable year must be derived from dividends,<sup>42</sup> interest,<sup>43</sup> rents from real property,<sup>44</sup> gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property) not property described in section 1221(a)(1),<sup>45</sup> abatements and refunds from taxes on real property,<sup>46</sup> income and gain from foreclosure property,<sup>47</sup> and amounts received as consideration for entering into agreements to make mortgage loans or to purchase or lease real property.<sup>48</sup> The overarching purpose of the 95percent test is to ensure that “entities qualifying as REITs operate as passive entities and do not engage in operating an active trade or business.”<sup>49</sup>

Under the second income test, 75 percent of a REIT’s gross income must be derived from rents from real property,<sup>50</sup> interests on obligations secured by mortgages on real property or interests thereof,<sup>51</sup> gain from the sale of real property or interests thereof, including

<sup>40</sup> “The term ‘real estate assets’ means real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other real estate investment trusts which meet the requirements of this part.” § 856(c)(5)(B). “The term ‘interests in real property’ includes fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.” § 856(c)(5)(C). “A regular or residual interest in a REMIC shall be treated as a real estate asset, and any amount includible in gross income with respect to such an interest shall be treated as interest on an obligation secured by a mortgage on real property.” § 856(c)(5)(E). The IRS also regards gains from the sale of timber gains from the sale of real property, provided certain conditions are met. § 856(c)(6)(H).

<sup>41</sup> § 856(c)(5)(C).

<sup>42</sup> § 856(c)(2)(A).

<sup>43</sup> § 856(c)(2)(B).

<sup>44</sup> § 856(c)(2)(C).

<sup>45</sup> § 856(c)(2)(D).

<sup>46</sup> § 856(c)(2)(E).

<sup>47</sup> § 856(c)(2)(F).

<sup>48</sup> § 856(c)(2)(G).

<sup>49</sup> Lynn, *supra* note 17, at § 2:28.

<sup>50</sup> § 856(c)(3)(A).

<sup>51</sup> § 856(c)(3)(B).

mortgages,<sup>52</sup> dividends and distributions on or gain from the sale of other REITs,<sup>53</sup> abatements and refunds of taxes on real property,<sup>54</sup> income or gains from foreclosure property,<sup>55</sup> amounts received as consideration for entering into agreements to make mortgage loans or to purchase or lease real property,<sup>56</sup> and qualified temporary investment income.<sup>57</sup>

By including the income and asset requirements, drafters of REIT legislation aimed to appease the concerns of some legislators that REIT status would be abused.<sup>58</sup> Thus, the asset and income requirements are meant to allow the benefit of REIT status only to those entities which passively invest in real estate related assets. Entities that do not meet the asset and income tests are subject to the traditional corporate tax.<sup>59</sup>

### C. Taxation of a REIT

The REIT is a distinct entity that is separate from its shareholders. Both the REIT and its shareholders have tax responsibilities that are proscribed in Section 857. A REIT, unlike a regular corporation, is required to pay out the bulk of taxable income to its shareholders each year.<sup>60</sup> In order to maintain REIT status, it must pay out at least ninety percent of taxable income for that tax year in dividends minus non-cash income such as accrued but not received revenue or cancellation of indebtedness income.<sup>61</sup> Taxable income generally includes ordinary operating income, such as rental income from an office building, or net interest income from investment in mortgage backed securities.<sup>62</sup>

REITs are prohibited from engaging in certain activities, such as selling property that is considered “stock in trade,”<sup>63</sup> or any sort of short

<sup>52</sup> §§ 856(c)(3)(C), 856(c)(3)(H).

<sup>53</sup> § 856(c)(3)(D).

<sup>54</sup> § 856(c)(3)(E).

<sup>55</sup> § 856(c)(3)(F).

<sup>56</sup> § 856(c)(3)(G).

<sup>57</sup> § 856(c)(3)(I).

<sup>58</sup> Lynn, *supra* note 17, at § 2:29.

<sup>59</sup> § 856(a)(3).

<sup>60</sup> I.R.C. § 857(a) (2006).

<sup>61</sup> § 857(a)(1)(A)(i)-(ii). Although these amounts are subtracted from taxable income, ninety percent of which must be distributed to shareholders, such amounts are still taxed by the IRS. § 857(b)(1), (e)(2)(C)-(D).

<sup>62</sup> There are other categories of income included in this formula, including capital gains income. *See* § 857(b)(2).

<sup>63</sup> I.R.C. § 1221(a)(1) (2006).

term “property flipping,” such as buying and renovating a property with the intent of selling it within two years of purchase.<sup>64</sup> If a REIT engages in this activity, not only is the income derived therefrom subject to a 100 percent tax, the entity may lose its REIT status altogether.<sup>65</sup> These prohibitions are in place to prevent abuse of the REIT tax structure by entities whose objective is not to buy and hold real estate related assets, which reinforces Congress’ intentions with the entity.

Provided the trust pays out at least 90 percent of its taxable income, it benefits from the REIT tax provisions and is allowed to deduct the distributions from the REIT’s own income tax return.<sup>66</sup> Any taxable income remaining is subject to ordinary corporate tax rates,<sup>67</sup> but since 90 percent of income must be distributed to maintain REIT status, the income subject to corporate tax rates will almost never be more than a small fraction of total income. In fact, many REITs pay out far more than the required distribution amount and subsequently face no tax liability at the REIT level.<sup>68</sup>

The taxable income considered in the minimum distribution requirement does not include capital gains income.<sup>69</sup> A REIT is not required to distribute capital gains income, but capital gains are taxed to the shareholders whether distributed or not. If a REIT retains capital gains income, the shareholder reports the amount of capital gain on their income tax return for the year in which the gain is realized.<sup>70</sup> The shareholder may then increase their basis in their shares to the extent of per share funds withheld by the REIT on which the shareholder paid taxes.<sup>71</sup>

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<sup>64</sup> I.R.C. § 857(b)(6) (2006 & Supp. 2008).

<sup>65</sup> § 857(b)(6)(A).

<sup>66</sup> § 857(b)(2).

<sup>67</sup> § 857(b)(1).

<sup>68</sup> National Association of Real Estate Investment Trusts Historical REIT Distributions for Tax Year 2011, <http://returns.reit.com/1099/2011/111099.pdf> (last visited Apr. 10, 2012).

<sup>69</sup> § 857(a)(1)(A)(i)

<sup>70</sup> § 857(b)(3)(D)(i)

<sup>71</sup> § 857(b)(3)(D)(iii)



#### *D. Taxation of REIT Shareholders*

Dividends paid by the REIT are not subject to the special 15 percent qualified dividend tax rate.<sup>72</sup> Thus, REIT distributions of taxable income (excluding capital gains income) are subject to the shareholders' individual ordinary income tax rates.<sup>73</sup> This is appropriate given that the distributions have not been taxed at the REIT entity level and therefore are not encompassed by the double taxation argument that covers "qualified" corporate dividends, which are taxed at the corporate level prior to distribution.<sup>74</sup>

Dividends from the REIT attributable to capital gains income are categorized separately by the REIT at the end of each taxable year as capital gain dividends.<sup>75</sup> Capital gain dividends are treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than one year.<sup>76</sup> Thus, income which would have been ordinary income in the hands of the REIT is ordinary income in the hands of a shareholder, and income which would have been capital gains income to the REIT remains such income to the shareholder. In this way too, REITs function like "pass-through" entities.<sup>77</sup>

As noted previously, many REITs distribute to shareholders funds well in excess of the amount required to satisfy REIT requirements. Indeed, many REITs distribute an amount even greater than their taxable net income.<sup>78</sup> This is due to a large depreciation expense most REITs, like many other real estate owners, incur. As depreciation is intended to reflect the diminished value of property over time, it is a non-cash expense.<sup>79</sup> The REIT incurs this non-cash depreciation

<sup>72</sup> I.R.C. § 1(h)(11)(D)(iii) (2006).

<sup>73</sup> I.R.C. § 301(c)(1) (2006).

<sup>74</sup> I.R.C. §§ 1(h)(11) (2006) & 11(a) (2006).

<sup>75</sup> § 857(b)(3)(C).

<sup>76</sup> § 857(b)(3)(B).

<sup>77</sup> However REITs, unlike some "pass through" entities, cannot pass on losses to shareholders, meaning that REITs can carry over these losses to future years, but shareholders cannot deduct REIT losses against any other item of income of the shareholder in the current year. 26 C.F.R. § 1.857-2 (2012).

<sup>78</sup> Taxation of REIT Common Share Dividends (1995-2010). National Association of Real Estate Investment Trusts Historical REIT Distributions, <http://returns.reit.com/1099/HistoricalDividendAllocationSummary.pdf> (last visited Mar. 17, 2012) (hereinafter "REIT Distribution Analysis").

<sup>79</sup> To analogize, one's car depreciates in value each year. This is an expense of ownership, despite the fact that in any given year, the depreciation expense does not actually require an outlay of cash. See BRUEGGEMAN & FISHER, *supra* note 10, at 280.

expense each year, but no actual cash expenditure is made by the REIT. Thus, the REIT often has accumulated cash in excess of that year's taxable income and capital gains income. Because this excess cash is not "income" as the IRC defines it, the REIT does not have to distribute it to shareholders, though many REITs do return the excess cash as a return of capital distribution.<sup>80</sup> As these distributions do not represent "income," they are not taxable as ordinary income to the shareholder, and each dollar of such non-taxable return of capital distributions received by a shareholder is applied against and thereby reduces the shareholder's adjusted basis in the stock.<sup>81</sup> Once a shareholder's basis is reduced to zero by such return of capital distributions, any subsequent return of capital distributions are taxed as capital gains.<sup>82</sup> When the shareholder eventually sells their shares, they will pay capital gains taxes on the amount of proceeds which exceed their adjusted basis in the shares of the REIT.<sup>83</sup>

### III. HISTORY OF THE REIT'S FORMATION

In order to understand REITs, it is helpful to understand their historical origin and evolution. The REIT legislation enacted in 1960 was modeled on legislation governing RICs, which are organized for the "purpose of providing expert centralized investment management to the securities-investing public free of corporate income tax liability under the federal income tax laws."<sup>84</sup> The ubiquitous mutual fund, a component of almost every American's retirement and general investing strategy, would not exist but for the RIC legislation. REIT legislation was based upon the RIC model, as the two entities share many

<sup>80</sup> REIT Distribution Analysis, *supra* note 78.

<sup>81</sup> Thus, if a shareholder in the 25% income tax bracket receives a \$2 distribution, \$.75 of which represents REIT income taxed as a dividend and \$1.25 of which represents a non-taxable return of capital, then the taxpayer owes \$.1875 in income tax (25% tax rate x \$.75). The shareholder's adjusted basis in the stock is also reduced by the amount of the tax-free return of capital distribution. Thus, if the shareholder's adjusted basis in the stock had been \$20 prior to the distribution, their new adjusted basis would be \$18.75 (\$20 - \$1.25 non-taxable return of capital). I.R.C. § 301(c)(2) (2006).

<sup>82</sup> § 301(c)(3)(A).

<sup>83</sup> Thus, if the shareholder in the above example collected the \$2 dividend distribution and immediately afterward sold their shares for \$20, they would owe capital gains tax for the \$1.25 which their sale proceeds now exceeded their adjusted basis (\$20 sale price - \$18.75 adjusted basis post non-taxable return of capital distribution).

<sup>84</sup> Laurence Channing, *Federal Taxation of the Income of Real Estate Investment Companies*, 36 TAXES-THE TAX MAGAZINE 502, 502 (1958); see also Lynn, *supra* note 17, at § 1.10.

qualities.<sup>85</sup> Both provide valuable capital to the market, and benefit their shareholders in that they can obtain access to expert investment managers and achieve the virtues of diversification through share ownership in the RIC or the REIT.

Congress enacted RICs in 1936.<sup>86</sup> Congress had acted in response to the Supreme Court's ruling in *Morrissey v. Commissioner*, which held that an entity that manages a transitory pool of assets is subject to corporate taxation, as it is an association rather than a trust.<sup>87</sup> This ruling had very negative implications for several investment syndicates that actively managed stocks and other securities, as it meant that these investment entities would now be subject to three levels of taxation.<sup>88</sup> Eager to avoid this result, Congress amended the IRC in 1936 to provide that companies organized as registered investment companies were allowed to "organize a corporation for the purpose of providing expert centralized investment management to the securities-investing public free of corporate income tax liability."<sup>89</sup>

The new RIC provision applied only to securities-investing, but not

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<sup>85</sup> Lynn, *supra* note 17, at § 1.10.

<sup>86</sup> BRUEGGEMAN & FISHER, *supra* note 10.

<sup>87</sup> *Morrissey v. Comm'r*, 296 U.S. 344, 360 (1935). In *Morrissey*, Chief Justice Hughes held that too many investment vehicles labeled "business trusts" were being held out to "provide a medium for the conduct of a business and sharing its gains." *Id.* at 349, 357. The petitioners in *Morrissey* had organized a trust in order to subdivide and develop a tract of land for residential purposes, and the powers of the trustees were inclusive of every power necessary to accomplish this objective, including "purchase, encumber, sell, lease and operate the 'described or other lands'; to construct and operate golf courses, club houses, etc . . . ." *Id.* at 347. Having argued that they were a strict trust, as the beneficiaries had no control over the trustees, as was the case in *Crocker v. Malley*, 249 U.S. 223 (1919), wherein a strict trust was found, Chief Justice Hughes distinguished the facts in *Morrissey*. He reasoned that since the "trust" in *Morrissey* was not concerned with "particular" property, only property yet to be acquired, the entity at issue had to pay a corporate tax, as it was more appropriately classified as an "association", upon which Congress had already imposed a method of taxation. *Id.* at 360; *see also SECREIT*, *supra* note 17, at § 1.9.

<sup>88</sup> An investment company which only owned securities of portfolio companies would already expose its shareholders to double taxation on dividends received from the securities of portfolio companies and paid on to the entity's own shareholders—once when the portfolio company paid tax on their income, and once when that income was remitted to the investment company's shareholders. If the investment company itself had to pay tax on those dividends received from portfolio companies as income, then the entity would face triple taxation. Channing, *supra* note 82. Similarly, the REIT model is premised on the belief that real estate investment companies should not force their shareholders to double taxation on income, when individuals who own property in other vehicles are only taxed once on income.

<sup>89</sup> Channing, *supra* note 84, at 502; *See also* Lynn, *supra* note 17, at § 1.10.

real estate investing—an ironic outcome considering Congress was motivated to amend the Code out of objection to the Supreme Court’s interpretation regarding the taxation of real estate investments.<sup>90</sup> This may have been due to the fact that, at the time of the RIC legislation, most real estate investment trusts were experiencing severe losses due to the dire economic climate of the Great Depression, and most trusts were not dealing with any tax problems, as there was little income to tax.<sup>91</sup> Whatever the reasons for not including real estate, the result was that, for the next twenty-four years, real estate investment syndicates were generally subject to two levels of taxation, which proved detrimental to the viability of any pooled form of investment for the purpose of acquiring real estate.<sup>92</sup>

By the 1950s, most trusts investing in real estate had been liquidated.<sup>93</sup> The tax treatment of their income made them worth more liquidated to non-corporate buyers rather than continuing under corporate-like ownership.<sup>94</sup> The major proponents of new legislation allowing for favorable tax treatment for real estate investment trusts included the National Association of Real Estate Boards, the National Association of Home Builders, and the Mortgage Bankers Association.<sup>95</sup> Interestingly, the Post Office Department, “which hoped [favorable tax treatment] would help to attract private capital into the construction of facilities to be leased to that Department, saw its prospective use in the depressed industrial area program, and the Housing and Home Financing Agency” also supported the adoption of favorable real estate investment trust tax treatment.<sup>96</sup> From its genesis, legislators and lobbyists saw the REIT instrument as a powerful new tool to promote liquidity in the economy, where real estate development was largely dependent on “[g]overnment-guaranteed money and investments by special groups, such as insurance companies and pension trusts.”<sup>97</sup>

In 1956, both the House of Representatives and the Senate passed a bill to amend the IRC of 1954 “to provide a special method of taxation

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<sup>90</sup> *Morrissey v. Comm’r*, 296 U.S. 344 (1935).

<sup>91</sup> Lynn, *supra* note 17, at § 1.11.

<sup>92</sup> *Id.* (discussing the difference in valuation of market price of stock of Real Estate Investment Trust of America and the book value of its underlying real estate).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> S. REP. NO. 2797, at 2 (1956).

for real estate investment trusts.”<sup>98</sup> The Committee on Ways and Means prepared a report on H.R. 4392.<sup>99</sup> In their report, the Committee on Ways and Means noted that:

regulated investment companies which distribute 90 percent or more of their ordinary income are taxed only on their retained earnings. In general, the beneficiaries of these companies are treated as if they had received the income directly from the same sources as the investment company. This conduit type of tax treatment is accorded by this bill to real estate trusts.<sup>100</sup>

The Committee on Ways and Means rested much of their reasoning upon the similarity between RICs and proposed REITs, and the report extolled the virtue of providing an opportunity for small investors to pursue compelling investment opportunities.<sup>101</sup> The report made the argument that Congress should remove taxation as a factor in what motivates the size of “investments in stocks and securities, on one hand, and real estate equities and mortgages, on the other.”<sup>102</sup> The Committee on Ways and Means’ rationale reflects the fact that taxation of commercial entities in different ways on the basis of their structure alone can create severe distortions in the national economy.<sup>103</sup>

Despite its dual-house passage, H.R. 4392 would not become law during the 84<sup>th</sup> Congress, as President Dwight D. Eisenhower withheld approval.<sup>104</sup> Eisenhower reasoned that regulated investment companies enjoyed the conduit treatment granted to them since 1936 because it merely avoided “an additional level of corporate taxation, which for dividend income consists of the tax on the portion of dividends remaining after the 85 percent inter-corporate dividends deduction.”<sup>105</sup> But the President felt it was inappropriate for real estate investment trusts to escape corporate taxation altogether.<sup>106</sup> Eisenhower also worried about the extent of real estate investment trusts’ potential abuse, noting that, contrary to the intention of Congress, the structure might be

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<sup>98</sup> H.R. REP. NO. 4392 (1956).

<sup>99</sup> S. REP. NO. 2797, at 2 (1956).

<sup>100</sup> *Id.* at 1.

<sup>101</sup> *Id.* at 2.

<sup>102</sup> *Id.*

<sup>103</sup> Vikas Bajaj, *Housing Lenders Fear Bigger Wave of Loan Defaults*, N.Y. TIMES, August 4, 2008, at A1.

<sup>104</sup> H.R. 4392, 84th Cong. (1956).

<sup>105</sup> *Id.*

<sup>106</sup> *Id.*

utilized by real estate companies, which had always carried on their activities as fully taxable corporations and did not need preferential treatment.<sup>107</sup> Apparently, he was not swayed by the public policy arguments in favor of capital raising and small investor accessibility.

Three years later, Dan Throop Smith, Under Secretary for Tax Policy of the Treasury and a persistent REIT legislation opponent, resigned from his position.<sup>108</sup> Shortly thereafter, the Treasury withdrew its objections to the allowance of special tax treatment for REITs.<sup>109</sup> Near the end of the Congressional term, both houses passed H.R. 10960 which outlined again the proposed method of taxation for REITs.<sup>110</sup> President Eisenhower then signed H.R. 10960 into law and officially amended the IRC.<sup>111</sup>

In the years since its initial passage, the success of the REIT model has gone far beyond the potential contemplated by its proponents. The market capitalization of REITs now totals over \$450 billion, comprised of 160 REITs.<sup>112</sup> Legislation since its creation has increased REITs' influence on many Americans' portfolio allocation considerations. The Tax Reform Act of 1986 further broadened the scope of the services REITs could provide to their tenants.<sup>113</sup> The Revenue Reconciliation Act of 1993 loosened restrictions on REIT ownership by tax-exempt entities such as pension funds.<sup>114</sup> The REIT Modernization Act of 1999 allowed REITs to own taxable REIT subsidiaries which could provide a broader set of services than the TRA of 1986 previously provided.<sup>115</sup> With the help of these amendments, REITs have graduated from a cottage industry to a legitimate and venerable investment vehicle.

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<sup>107</sup> *Id.*

<sup>108</sup> Lynn, *supra* note 17, at § 1:11.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> National Association of Real Estate Investment Trusts, *Historical REIT Industry Market Capitalization: 1972-2011*, REIT.COM, <http://www.reit.com/IndustryData/US-REIT-Industry-MarketCap.aspx> (last visited Feb. 22, 2012).

<sup>113</sup> I.R.C. § 856(d) (Supp. 1987).

<sup>114</sup> Lynn, *supra* note 17, at § 1:32.

<sup>115</sup> I.R.C. § 856(d) (Supp. 2001).

#### ***IV. WHY REITs FAIL TO ACHIEVE FULLY ALL OF THEIR LEGISLATIVE GOALS***

As discussed above, REIT legislation was principally motivated by an intention to allow small investors the benefits of real estate investment. Two aspects of the current statute impede full realization of that goal. First, those who invest in real estate through a REIT, rather than directly or through a partnership, get no adjustment to basis for the purchase amount of real estate financed with non-recourse debt. Second, real estate, other than land, is considered depreciable property,<sup>116</sup> but shares in a REIT are not. However, when a partnership or private investor purchases a piece of real property, regardless whether that property is brand new or fifty years old, they are allowed to claim depreciation deductions against income each year until their tax basis in the property is zero.<sup>117</sup> For partnership investors and direct owners, this has the effect of lowering taxable income during the depreciation period, which increases after-tax cash flow yields. When an investor purchases a share in a REIT, the shares are not depreciable as such. Furthermore, if a REIT owns property that has been fully depreciated, then a new REIT share investor cannot enjoy any reduction in taxable income through depreciation deductions, even though the underlying property would be fully depreciable to a buyer who purchased the property from the REIT.

##### *A. Inequitable Limitation of Basis*

The shortcomings of REITs are largely due to Congress's decision to model them on RICs, which were modeled on a modified corporate tax structure.<sup>118</sup> There are important differences between RICs and REITs that Congress failed to fully recognize. Shares of a RIC have no different tax attributes than the assets they hold, namely shares of other corporations. Therefore, whatever the tax treatment of the type of assets they hold, investors in RICs incur no greater tax burden as shareholders of the RIC than do direct holders of the shares that the RIC holds. Real property, however, does not share the same tax attributes as shares of a REIT. As mentioned above, real property, other than land, is depreciable- shares of a REIT are not. This difference results in lower

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<sup>116</sup> I.R.C. § 168(c) (2006).

<sup>117</sup> *Id.*

<sup>118</sup> See generally I.R.C. § 852 (2006, Supp. 2007 & Supp. 2010).

after tax returns of REIT shares versus other forms of real estate ownership such as direct ownership, partnership, or LLC ownership. Limitations in basis recovery inherent in share ownership of a REIT means its shareholders pay more taxes and enjoy fewer benefits than other real estate investors using other ownership vehicles.

Under the Regulations, distributions made by a REIT are subject to the same statute that governs distributions made by a corporation under IRC Section 301.<sup>119</sup> Section 301 states that the portion of a distribution which is not a dividend (dividends are comprised of ordinary and capital gains income under this definition) shall apply against and reduce the adjusted basis of the stock.<sup>120</sup> Once the basis in the stock is zero, each non-dividend distribution<sup>121</sup> is treated as capital gains income.<sup>122</sup> Thus, when a REIT has cash in excess of net income to distribute to shareholders, as in the situation discussed previously where non-cash expenses like depreciation reduce net income, the cash distribution will be treated as a non-dividend distribution which reduces the basis of the stock. When the basis of the stock has been reduced to zero, any future non-dividend distribution will be taxed as a capital gain.

The inequity lies in the fact that the basis of the REIT shareholder's stock will almost always be much lower than the basis of the real estate owned by the REIT. The court in *Crane v. Commissioner* held that the basis of real estate purchased includes the portion financed with debt.<sup>123</sup> To be sure, the REIT itself gets basis credit for the entire real property. However, since the shares of a REIT typically reflect only the equity value of the underlying real estate, shareholders, limited in their basis to the value of their shares, have a much lower tax basis in their investment. This disparity results in greater taxation of the investor's cash flow over time.<sup>124</sup> Taxpayers who own real estate

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<sup>119</sup> 26 C.F.R. 1.856-1(e)(2) (2012).

<sup>120</sup> I.R.C. § 301(c)(2) (2006).

<sup>121</sup> Those distributions which would otherwise be considered non-taxable returns of capital. § 301(c)(3)(A).

<sup>122</sup> § 301(c)(3)(A).

<sup>123</sup> See *Crane v. Comm'r*, 331 U.S. 1, 14-15(1947) (holding that a real estate owner's basis in a piece of property is the price they paid for that asset, which includes any amount financed, not merely their initial cash outlay). This principle stands even in cases where a taxpayer's financing of an asset was effected with non-recourse debt, where the taxpayer bears no personal liability as to the financed amount, and thus faces no real economic risk as to the debt.

<sup>124</sup> The more debt a REIT utilizes in purchasing real estate, the greater the discrepancy between a REIT shareholder and a direct real estate owner or a member of an LLC or a



through non-corporate vehicles other than REITs, and thus whose bases are not limited by the corporate definition, will have significantly more basis to offset non-dividend distributions before such distributions generate capital gains tax liability. Thus, a REIT shareholder will enjoy the benefit of non-dividend distributions for a much shorter period of time than a non-REIT real estate investor. This inequity exists even if a non-REIT real estate investor taxpayer made no greater an economic investment than a REIT shareholder. This is at the very least an unfortunate discrepancy,<sup>125</sup> and is particularly disappointing given Congress's egalitarian motivations at the time of the REIT's creation.<sup>126</sup>

*B. Inability to Depreciate Cost Basis for New REIT Share Purchaser*

The ability to depreciate the value of buildings, furniture, and fixtures, which make up most of the composition of real estate property,<sup>127</sup> is one of the greatest tax benefits available to real estate investors.<sup>128</sup> Long celebrated by investors and Congress- as evidenced by their unwillingness to modify it- as a fully sacred legal fiction,<sup>129</sup> the IRC allows real estate investors to straight line depreciate their real estate holdings all the way down to zero over a period of 27.5 years for rental residential property and thirty-nine years for non-residential property.<sup>130</sup>

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partner in a partnership, as the REIT shareholder receives no basis for the debt of the REIT. I.R.C. § 301(c) (2006).

<sup>125</sup> Assume that the amount of money an investor put down to purchase real estate directly or through a partnership was equivalent to the amount of money spent buying shares in a REIT.

<sup>126</sup> H.R. REP. NO. 2020, at 3.

<sup>127</sup> Land is not depreciable. 26 C.F.R. § 1.167(a)-2 (2012).

<sup>128</sup> See MARVIN A. CHIRELSTEIN, *FEDERAL INCOME TAXATION* 162 (Foundation Press 11th ed. 2009).

<sup>129</sup> *Id.*

<sup>130</sup> A direct or partnership owner of a residential rental property can enjoy depreciation deductions against their rental income for as long as 27.5 years. As the value of the property is depreciated down to zero, over a 27.5 year time frame, this amounts to a depreciation deduction of 3.636% of the real estate asset's value each year for 27.5 years. What this dynamic means for a typical real estate investor, who often times borrows 80% or more of an investment property's purchase price, is that they can enjoy depreciation benefits against investment income long after they recouped their initial capital outlay. Therefore, a real estate investor who purchased a property for \$1,000,000, putting only \$100,000 down and financing the other \$900,000 would be able to deduct \$36,360 from their rental income each year for 27.5 years. Considering this hypothetical investor's initial cash outlay was only \$100,000, they recouped the cost of their initial investment tax free after less than three

The REIT entity itself, as owner of depreciable real property, is entitled to depreciate its investment property over the appropriate depreciation schedules, meaning 27.5 or thirty nine years. However, REITs, as mere creatures of the tax Code,<sup>131</sup> pass on substantially all of their income to their shareholders, and thus pay very little in taxes anyway.<sup>132</sup> Thus, the ability to depreciate asset purchases such as buildings and fixtures should rightly pass to subsequent shareholders, who are actually bearing the economic risk of their investment.

This allocation of depreciation expenses to REITs rather than their shareholders presents a problem when REIT shares are sold to subsequent shareholders. Although the price a REIT shareholder pays for the shares generally reflects the current value of the underlying real estate without regard to tax depreciation, that real estate may have been purchased by the REIT several years ago, and thus may already be fully depreciated for tax purposes.<sup>133</sup> The new shareholder's current investment cannot be depreciated appropriately to fully reflect the economic outlay by the shareholder, which would involve equalizing the shareholder's "outside basis" with their share of the REIT's "inside basis." This can result in unjust depreciation deductions on both sides of the spectrum, meaning too little a deduction in the case of REIT-owned appreciated property or even too great a deduction in the case of REIT-owned depreciated property.<sup>134</sup> Essentially, it is another

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years ( $100,000/36,360 = 2.7503$ ), regardless of whether or not they are exposed to any remaining personal liability on the \$900,000 financed amount.

<sup>131</sup> BRUEGGEMAN & FISHER, *supra* note 10.

<sup>132</sup> I.R.C. § 857(a) (2006).

<sup>133</sup> I.R.C. § 168(c)(2006).

<sup>134</sup> If a residential rental property has been held by REIT X for 25 years, and therefore has only 2.5 years remaining on its depreciation schedule, REIT X shares purchased today by subsequent Investor A only have 2.5 years of remaining depreciation charges against income. Note that any annual depreciation charges remaining on a 27.5 year schedule set 25 years ago based on the then-current price paid for the property are most likely grossly disproportionate to the current value of the property (nowhere near 3.636 percent, or  $1/27.5$ , of the current property value). Conversely, if REIT Y purchased a residential rental property two years ago and the value of the property is now only 60 percent of its purchase price, the 27.5 year depreciation schedule nonetheless continues based on the purchase price two years ago. Thus, if Investor B purchases shares their REIT Y shares today, although the price they paid for the shares would generally reflect the forty percent decline in property value, the annual depreciation deduction is far larger than  $1/27.5$  of the current value of the property. Lastly, though the first hypothetical situation is far more common, in either situation, Investor A and Investor B are forever missing out on the years of depreciation charges that occurred before they became REIT shareholders. This increases their taxable income once the depreciation schedule is fully exhausted, and is a further

unfortunate result of the entity structure chosen by Congress with regard to REITs which further diminishes after-tax returns for investors.

#### V. THE REAL ESTATE MARKET OF 2002-2007

The downturn of the last several years has been widely regarded as the most severe economic recession since the 1930s.<sup>135</sup> Since the start of the current recession, once venerable financial institutions such as Bear Stearns, Countrywide Financial, Lehman Brothers, AIG, Fannie Mae, Freddie Mac, Washington Mutual, Merrill Lynch, and Wachovia have either failed, been sold to maintain solvency, or gone under the conservatorship of the federal government to minimize potential damage to the broader economy.

The roots of the crisis can be traced in part to the actions of unsophisticated small investors in mostly residential real estate. Desperate to secure entry to one of the best performing asset classes, buyers bid up prices for homes that would sell for less than half that amount two years later.<sup>136</sup> A highly complacent lending and finance industry provided the needed ammunition for such a bidding frenzy, and mainstream banking institutions like Washington Mutual in fact built a business model around hyper-aggressive lending.<sup>137</sup> As home prices had not fallen on a national scale since the Great Depression,<sup>138</sup> lenders felt comfortable loaning money, not only to subprime customers, but also to customers with higher credit scores based on minimal financial information.<sup>139</sup> One humorous, if not disturbing, anecdote divulged by a former employee of one of Washington Mutual's mortgage processing centers involved a mariachi singer applying for a mortgage, claiming to earn a six-figure income. As his financials were not verifiable by the bank, the employee "had him photographed in front of his home dressed in his mariachi outfit."<sup>140</sup> Employees familiar with the "mariachi file"

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illustration of the REIT tax form inequitably depriving investors of the tax benefits available to other real estate investors, despite identical economic investments.

<sup>135</sup> Peter Goodman, *Joblessness Hits 9.5%, Deflating Recovery Hopes*, N.Y. TIMES, July 2, 2009, at A1.

<sup>136</sup> *The Decade in Review*, ORLANDO SENTINEL, Dec. 31, 2009, at B1.

<sup>137</sup> Peter Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008, at A1.

<sup>138</sup> Jagadeesh Gokhale, *The Perfect Financial Storm* (Sept. 26, 2008), available at [http://www.cato.org/pub\\_display.php?pub\\_id=9668](http://www.cato.org/pub_display.php?pub_id=9668) (last visited Feb. 22, 2012).

<sup>139</sup> Goodman & Morgenson, *supra* note 137.

<sup>140</sup> *Id.*

used it for inspiration when processing mortgage loan applications for babysitters claiming to earn one hundred thousand dollars and landscapers claiming to earn twelve thousand dollars per month.<sup>141</sup> In fact, their company's slogan for several years during the housing boom was, "The Power of Yes."<sup>142</sup>

Washington Mutual was hardly alone in their reckless behavior. World Savings Bank, which would later become a wholly owned division of Wachovia, virtually created the market for a product they called the "Pick-A-Pay" mortgage, more generally referred to as an option adjustable rate mortgage ("ARM").<sup>143</sup> Also referred to as negative amortization loans due to the potential for the loan balance to increase, these loans allowed homeowners to make monthly mortgage payments that were so small they did not cover their interest charges.<sup>144</sup> Though negative amortization loans were used in the 1980s due to soaring interest rates and the desire of borrowers to be able to predict their monthly payment, the "Pick-A-Pay" product thrived during a much lower interest rate period. Negative amortization loans were not being used to manage sky high interest rates, but rather sky high home prices. "Of the \$238 billion in option ARM loans made in 2005, World Savings Bank issued about \$52 billion, or more than one-fifth of the total."<sup>145</sup> Ultimately drawing in customers with promises of initial "teaser rates" of one percent, the "Pick-A-Pay" program attracted many customers with financial resources that were difficult to verify.<sup>146</sup> The bank was all too happy to initiate a loan, even one whose principal may never decline, against a house that represented an asset that was thought could only increase in value.

Washington Mutual's lending practices and World Savings' "Pick-A-Pay" mortgage product contributed to a devastating home price decline that was unprecedented in modern U.S. history. As the "Pick-A-Pay" loans were marketed as a short-term bridge loan between refinancings for borrowers with strained or hard to predict financial resources, these loans came to symbolize the shortsightedness and irrational exuberance of the lending industry. "In New Jersey, there

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<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> Michael Moss & Geraldine Fabrikant, Once Trusted Mortgage Pioneers, Now Pariahs, *N.Y. TIMES*, Dec. 25, 2008, at A1.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.*

<sup>146</sup> *Id.*

were 17,525 option ARMs. . .outstanding at the end of June [2009], and 11.4 percent of the homeowners with these loans are at least [thirty] days delinquent on their payments.”<sup>147</sup> With the three to five year low rate period expiring on many option ARM loans, “their payment time bomb is ready to explode.”<sup>148</sup>

It is disconcerting that investors are slow to learn lessons from asset bubble deflation. David Simon, Chief Executive Officer of Simon Property Group, one of the preeminent mall REITs in the United States, said in September 2009, when the real estate market decline was well underway,<sup>149</sup> that even seemingly sophisticated investors such as commercial property owners still sought to hold on to their properties, and expected to receive at least twelve times the cash flow before considering parting with their real estate.<sup>150</sup> According to Simon, “there [was] still a decent bid and ask difference between the buyer and the seller.”<sup>151</sup> This illustrates that property owners do not fully recognize the irrationality of real estate prices of the past six years, and may not be so easily discouraged from risking their money.<sup>152</sup> Robert Shiller, a professor of economics at Yale, wrote in a New York Times article:

[A]t the moment, it appears that the extreme ups and downs of the housing market have turned many Americans into housing speculators. Many people are still playing a leverage game, watching various economic indicators as well as the state of federal bailout programs — including the \$8,000 first-time home-buyer tax credit that is currently scheduled to expire before Dec. 1 [2009].<sup>153</sup>

Congress, in its countless efforts over the past three years to stoke the real estate market, may merely encourage the same type of

<sup>147</sup> Bob Tedeschi, A Reckoning on Option ARMs, *N.Y. TIMES*, Sept. 20, 2009, at RE10.

<sup>148</sup> *Id.*

<sup>149</sup> See *Moody's/REAL Commercial Property Index (CPPI)*, MIT CENTER FOR REAL ESTATE, <http://mit.edu/cre/research/credl/rca.html> (last visited Apr. 10, 2012); *House Prices Increase Slightly in Third Quarter*, FEDERAL HOUSING FINANCE AGENCY, <http://www.fhfa.gov/webfiles/15233/3q09HPI.pdf> (last visited Apr. 10, 2012).

<sup>150</sup> Daniel Taub, *Real Estate Rebound Will Reap '04 Prices, Simon Says*, Sept. 16, 2009, <http://www.bloomberg.com/apps/news?pid=20601103&sid=ajKw7NSn6EMU> (last visited Mar. 4, 2010).

<sup>151</sup> *Id.*

<sup>152</sup> According to a recent New York Times article, when homeowners were asked, “How much of a change do you expect there to be in the value of your home over the next 12 months?”...the average answer for June-July 2009 was a 2.3 percent rise, versus a negative 0.4 percent a year earlier.” Robert Schiller, *A Bounce? Indeed. A Boom? Not Yet*, *N.Y. TIMES*, Oct. 10, 2009, at BU4.

<sup>153</sup> *Id.*

speculation that created the asset bubble the first time. It would be preferable to encourage small investors to invest in real estate through REITs rather than directly because REITs have access to sophisticated advice and spread risk over a substantial number of assets. But to make REITs a viable alternative to direct ownership, it is essential to close the gap in the tax treatment of REITs and direct real estate investment.

## VI. A PROPOSED EQUALIZING SOLUTION

Given the favorable tax treatment and the ability to create long term financial stability, it is not difficult to understand why most methods of real estate investment are attractive. Though it may be accurate, it is not constructive to blame borrowers for being too speculative with their real estate investments. If Congress merely respects equitable principles in amending the IRC, investors may realize that many of their return objectives are achievable through REIT share investment. Congress should make investing in a REIT as attractive from a tax perspective as passive investment in real estate through a partnership or LLC.

REITs, partnerships, and LLCs employ debt to finance their real estate investments, and a form of debt used in such commercial settings is non-recourse debt. Non-recourse debt is debt wherein the lender may only look to the value of the underlying collateral securing the debt for recovery in the event of default, and thus no one bears the economic risk of loss for that debt.<sup>154</sup> The difference between REITs and partnerships and LLCs is that limited partners in a partnership and members in a LLC receive an increase in their outside basis due to the existence of non-recourse liabilities—not just the value of their equity as in the case of REIT investors.<sup>155</sup>

This Article proposes that REIT investors be granted a basis<sup>156</sup> that includes the amount of non-recourse debt that finances the purchase of property, thereby increasing the amount of return of capital distributions that a REIT investor can receive tax-free. This would thereby grant the same treatment to REIT investors that partnership limited partners and

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<sup>154</sup> 26 C.F.R. § 1.752-1(a)(2) (2012).

<sup>155</sup> I.R.C. § 752(a) (2006); 26 C.F.R. § 1.752-3(a) (2012).

<sup>156</sup> This reference to investors' basis in their investment is commonly referred to as "outside basis." H. Karl Zeswitz, Jr., *Allocation of Partnership Liabilities and Non-Recourse Deductions*, SL013 ALI-ABA 161, 169 (2006).

LLC members receive.<sup>157</sup> This change would ensure that a shareholder in a REIT employing non-recourse leverage will enjoy tax free return of capital distributions for longer than is currently possible, where only the share investment of the shareholder is considered in determining basis. Although this adjustment would not increase basis with regard to recourse leverage, it may encourage REIT managers to obtain non-recourse leverage in order to ensure favorable tax treatment for shareholders.

Historically speaking, the equity value of REITs tends to rise.<sup>158</sup> Furthermore, REIT shareholders may buy shares in the REIT several years after the REIT itself purchased a piece of real estate, which will inevitably cause a depreciation schedule discrepancy between the REIT's cost basis in the underlying real estate, and the investor's cost basis in the shares of the REIT. Such a mismatch occurs even in the rare situation where underlying real estate has not risen or fallen in value since the REIT acquired it, as the new investor in shares of the REIT will nonetheless miss out on the benefit of a full 27.5 or thirty-nine year depreciation schedule. Supposing the underlying real estate has been fully depreciated, subsequent shareholders will generally not receive any non-taxable distributions with which they could recover any of the cost of their investment prior to selling their shares. Partnership tax law contemplates this circumstance with an election that this Article proposes should extend to REITs.

In order to avoid non-depreciability of appreciated assets for a new partner in the partnership context, Congress enacted Section 754, which allows the partnership an alternate basis allocation, in the manner provided for by Section 743(b).<sup>159</sup> Section 743(b) says that "in the case of a transfer of an interest in a partnership by sale or exchange. . . a partnership. . . shall increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted

<sup>157</sup> If a partnership agreement is silent as to the partners' distributive shares or an allocation lacks substantial economic effect, then the partners' share of gain, loss, deduction or credit is determined in accordance with the partners' interest in the partnership. I.R.C. § 704(b) (2006); 26 C.F.R. § 1.704-1(b)(3)(i) (2012).

<sup>158</sup> E. Todd Briddell, *Public and Private Real Estate: Room for Both in a Diversified Portfolio*, URDANG, <http://www.reit.com/Portals/0/PDF/PublicPrivateRealEstateURDANG07262011.pdf> (last visited Apr. 13, 2012)

<sup>159</sup> I.R.C. § 754 (2006).

basis of the partnership property.”<sup>160</sup> This Article proposes that Congress should allow REITs to make a similar election to adjust basis for shareholders so that a shareholder who purchases shares in a REIT can depreciate their own basis in the REIT based on the then-current value of the interest.<sup>161</sup> Similar to the way a partnership passes through separate items of income and deductions,<sup>162</sup> a REIT could pass through a separate item of deduction that would be available to offset otherwise taxable dividend distributions from the REIT.

Some tax observers may argue that the proposals put forth by this Article would require an amount of administrative recordkeeping that would overburden real estate investment trusts. However, in the context of publicly-traded-partnerships, which, as publicly traded entities, have similarly burdensome numbers of shareholders and assets to value for the purposes of the Section 754 election, many of such partnerships make the election, utilizing various conventions for the purposes of valuing each unit-holder’s tax basis.<sup>163</sup> Thus, given that publicly-traded partnerships make Section 754 elections, it is difficult to imagine that REITs would be unable to do the same.

Furthermore, tax observers may consider that such proposals would provoke the Internal Revenue Service (“IRS”) to reconsider their long-held view that REIT share ownership does not generate unrelated business taxable income to a tax-exempt investor.<sup>164</sup> Unrelated business taxable income generally results in taxable income despite tax-exempt ownership.<sup>165</sup> Indeed, the IRS’s position in Revenue Ruling 66-106 was based on the fact that REITs are similar to C Corporations in their entity

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<sup>160</sup> I.R.C. § 743(b) (2006).

<sup>161</sup> For an explanation of how basis adjustment affects items of deduction, such as depreciation, refer to 26 C.F.R. § 1.743-1(j)(4) (2012).

<sup>162</sup> I.R.C. § 702 (2006).

<sup>163</sup> See Rule 424(b)(4) LRR Energy, L.P., Prospectus, 215, available at [http://sec.gov/Archives/edgar/data/1519632/000104746911009407/a2206357z424b4.htm#u73001\\_material\\_tax\\_consequences](http://sec.gov/Archives/edgar/data/1519632/000104746911009407/a2206357z424b4.htm#u73001_material_tax_consequences) (last visited Feb. 22, 2012) (discussing how the publicly-traded partnership makes the 754 Election); See also Rule 424(b)(4) Kinder Morgan Energy Partners, L.P., Prospectus, 12, [http://sec.gov/Archives/edgar/data/888228/000110465912010145/a12-3510\\_1424b3.htm#MaterialFederalIncomeTaxConsequen\\_135731](http://sec.gov/Archives/edgar/data/888228/000110465912010145/a12-3510_1424b3.htm#MaterialFederalIncomeTaxConsequen_135731), (last visited Feb. 22, 2012) (discussing a convention by which all unit-holders who purchase during the same month are treated identically for 754 Election depreciation schedule purposes, in order to ease the administrative burden of the election).

<sup>164</sup> Rev. Rul. 66-106, 1966-1 C.B. 151.

<sup>165</sup> I.R.C. § 501(b) (2006).



structure and dividend calculations.<sup>166</sup> As such, the IRS reasoned, tax-exempt shareholders should be able to hold REIT shares in certain tax-exempt accounts without generating unrelated business taxable income from REIT distributions, as the IRS permits certain tax-exempt beneficial owners to receive C corporation dividends without generating unrelated business taxable income.<sup>167</sup> To the extent that this Article proposes changes to make REITs more similar to partnerships in calculating basis for shareholders, the IRS may reconsider their position regarding unrelated business taxable income generated by REITs. Nonetheless, Congress's stated motivations at the time of the REIT's enactment were to benefit investors of limited means who otherwise could not invest in real estate. This class is not limited to tax-exempt investors, and thus this Article's proposed changes would comport further with Congress's stated goals.

## VII. CONCLUSION

Real estate remains an investment class that enjoys several advantages compared to other assets. Given the support the government provides real estate with beneficial tax treatment, small investors are wise to seek ownership of real estate. But if the performance of real estate over the past five years has taught the public anything, it is that the purpose of a home should be a living place, not a vehicle for aggressive speculation. Real estate investment trusts, created by Congress and intended to provide the benefits of real estate investment to the investor of limited means, have stopped short of the potential due to the basis recovery and allocation limitations. However, REITs are generally managed by real estate experts and typically employ less leverage than a typical private real estate investment. They could be a valuable component of an individual's portfolio, giving them the exposure to real estate on a more appropriate scale than other more speculative alternatives. Furthermore, REITs could be a powerful stabilizing force in an economy that just recently experienced what can happen when investors blinded by exuberance try to own an asset on a scale beyond their management and financial capabilities.

The changes proposed in this Article would possibly make REIT share ownership more attractive to small investors whose ill-advised

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<sup>166</sup> *Id.* This is in marked contrast to partnership interests, which the IRS contends generate unrelated business taxable income for tax-exempt trusts. I.R.C. § 513(b)(2006).

<sup>167</sup> *Id.*

investments contributed to the current crisis, and thereby reduce the likelihood of such a destructive asset bubble's formation. However, at the very least, they would establish greater equality in the treatment of REIT owners and other non-corporate investors in real estate, which is an objective Congress would be wise to consider.